

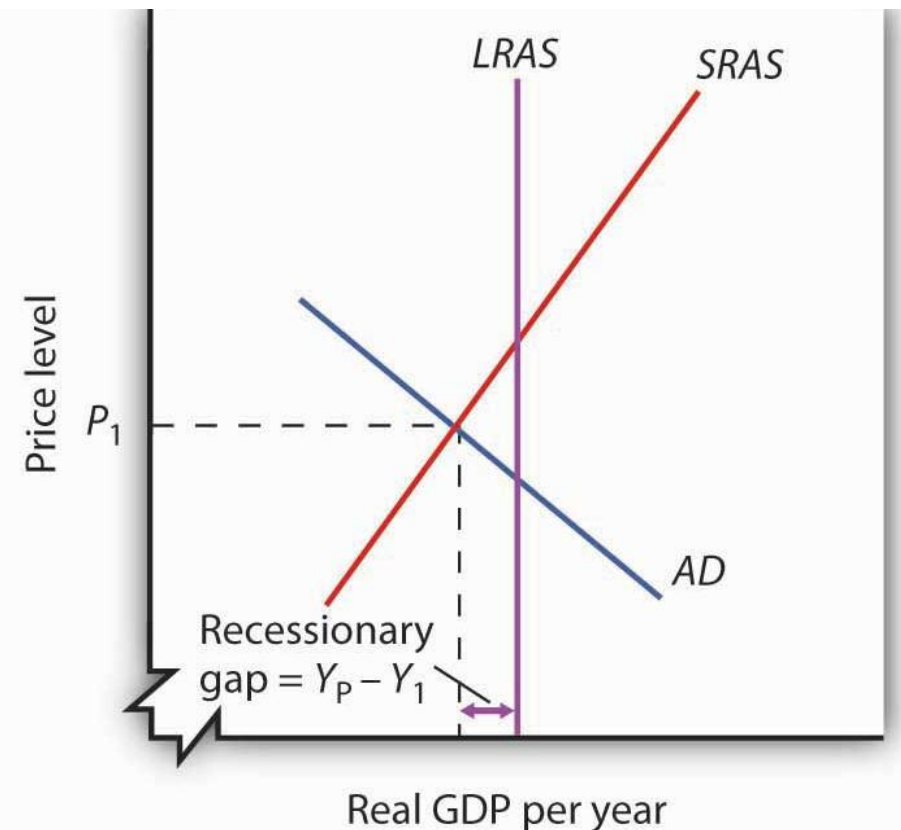
Classical Economic Theory: Short-Run to Long-Run

Basic Assumptions of CT

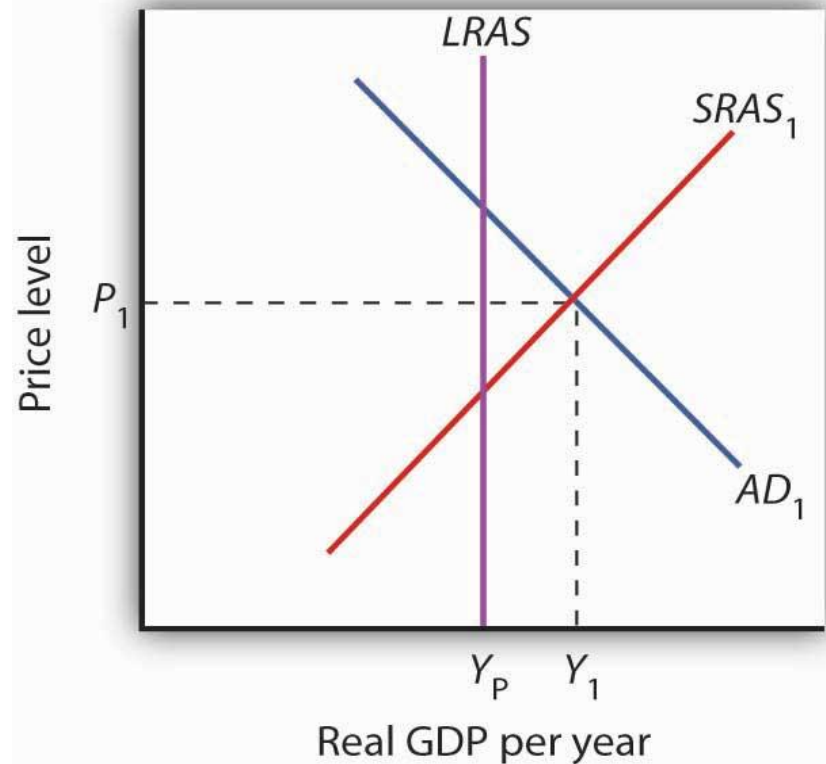
- Economy is completely capable of self-correction
 - No Government or central bank (FED) influence is needed
- In the long run, ALL things are flexible
 - Wage contracts re-negotiated, resource prices reflect demand, information is gathered

Most economies experience two basic problems

Recessionary Gaps



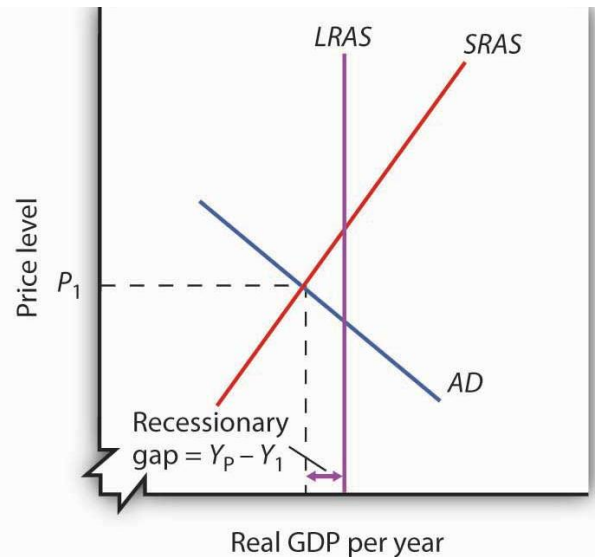
Inflationary Gaps



Most economies experience two basic problems

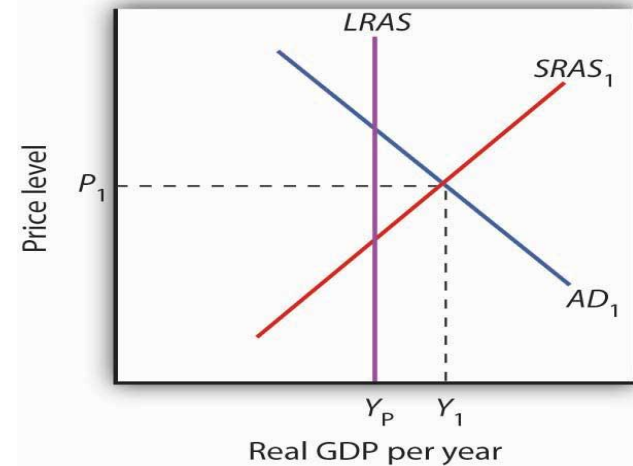
Recessionary Gaps

- Actual RGDP is LESS than FULL employment RGDP
- Unemployment is high
- Many unused resources



Inflationary Gaps

- Actual RGDP is MORE than Full Employment GDP
- Unsustainable strain on resources
- Inflation is likely or already occurring

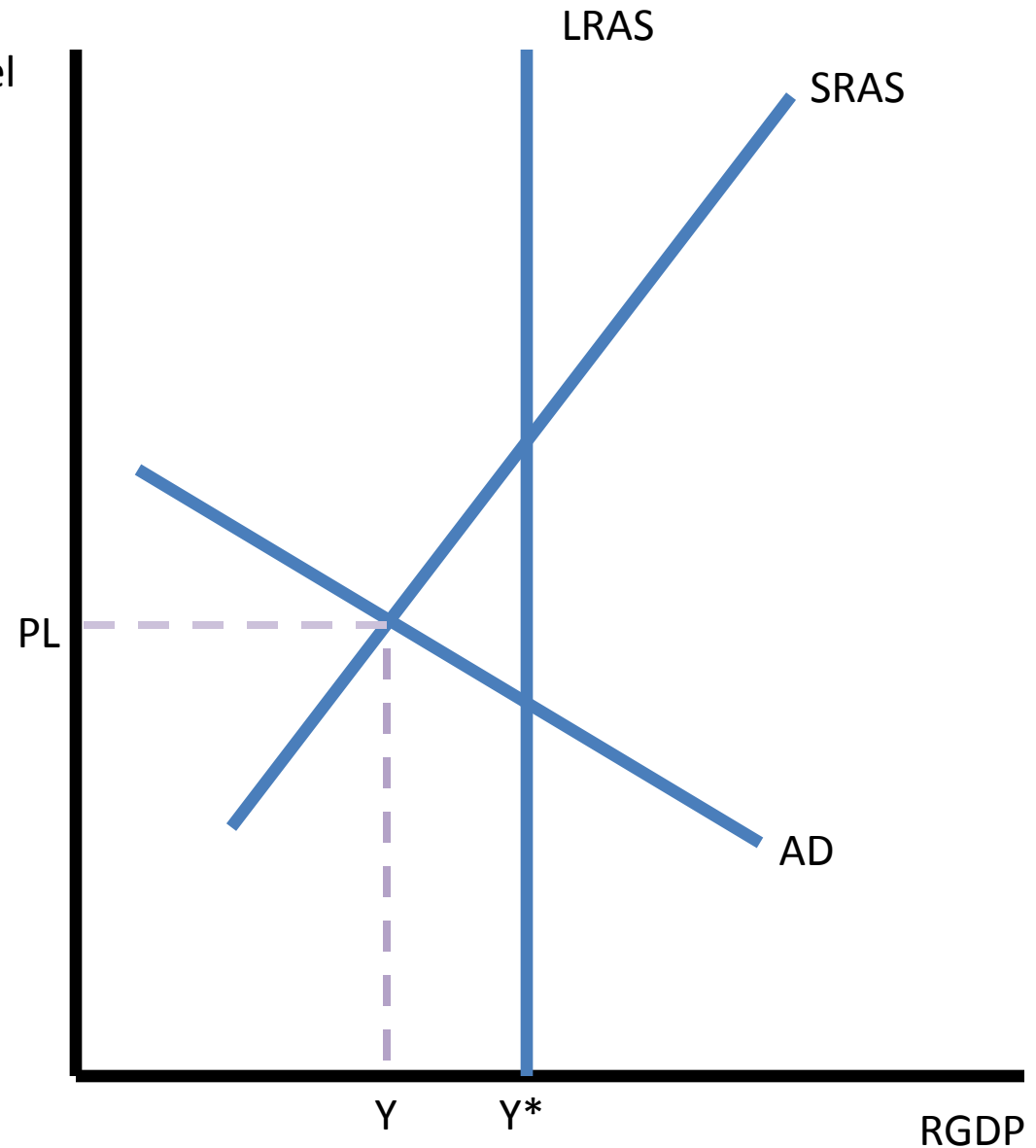


CT Explanation of Recessionary Gaps

Assumptions:

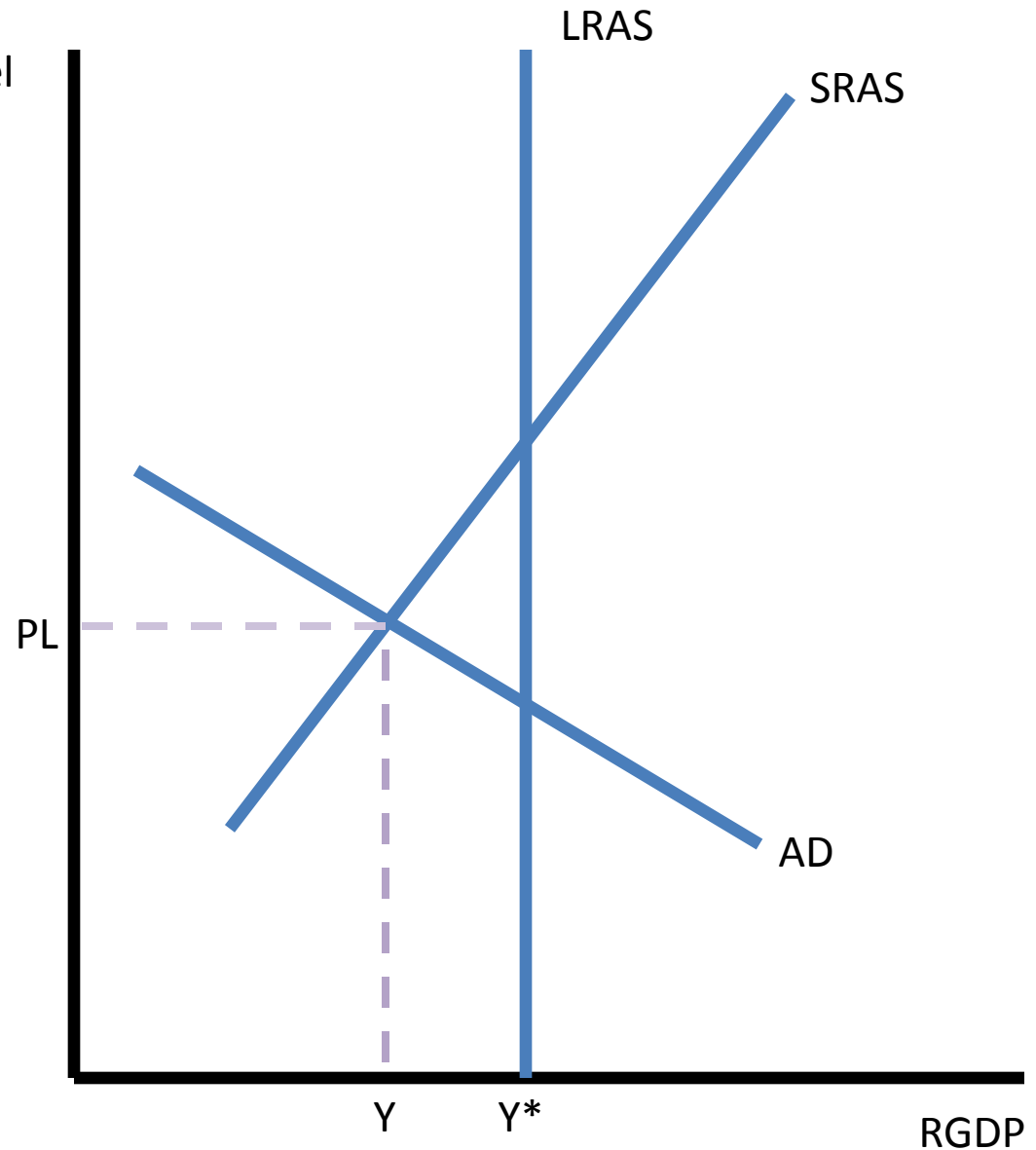
-The economy is producing at PL and Y. Full employment is Y^* .

-NO government or central bank action is taken



CT Explanation of Recessionary Gaps

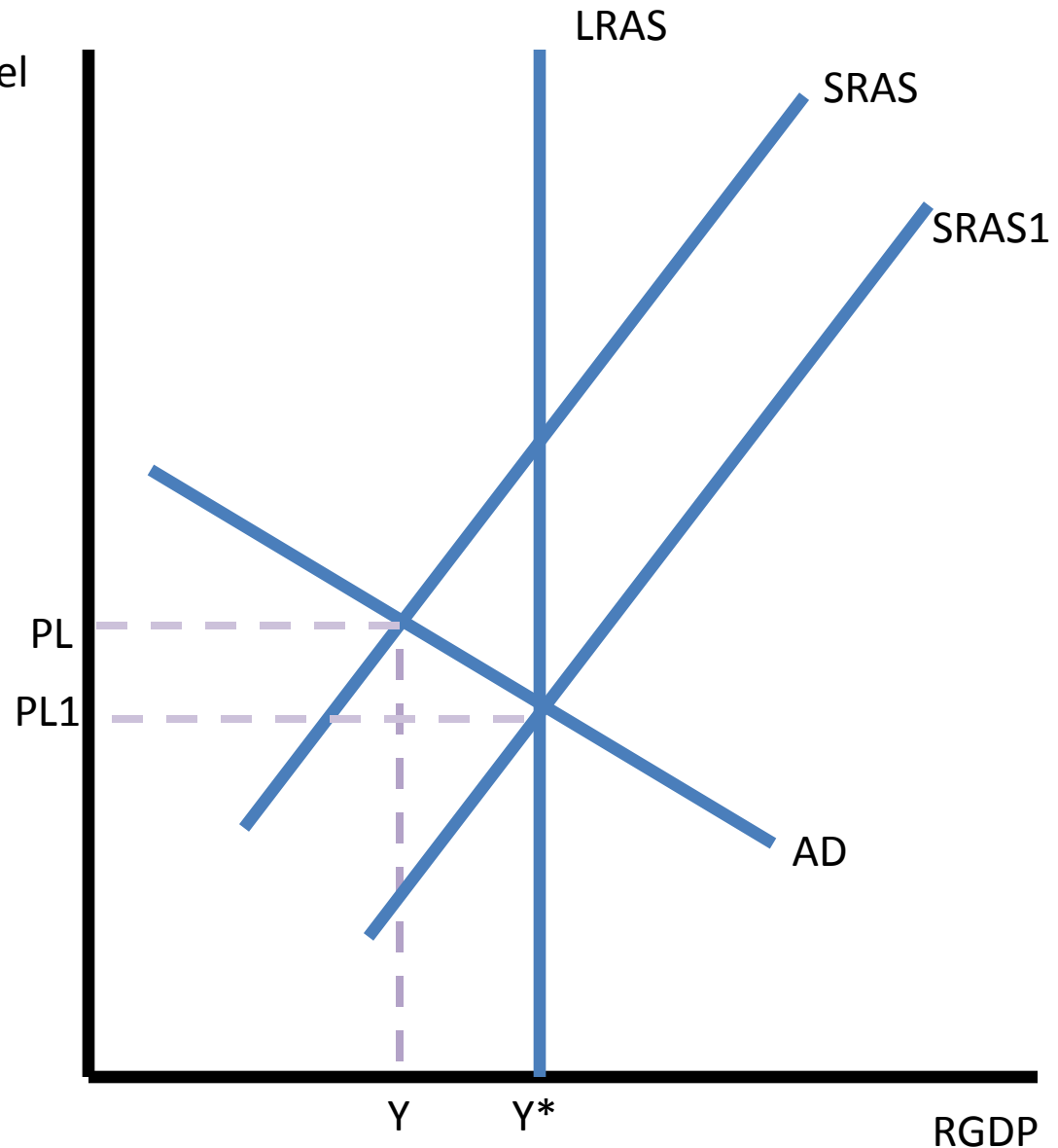
1. The higher level of unemployed resources will eventually lead to cheaper prices for those resources, **especially LABOR as people accept lower wages over time.**
2. Price of labor is a primary input to SRAS. Cheaper labor allows for businesses to produce more goods at all possible prices.



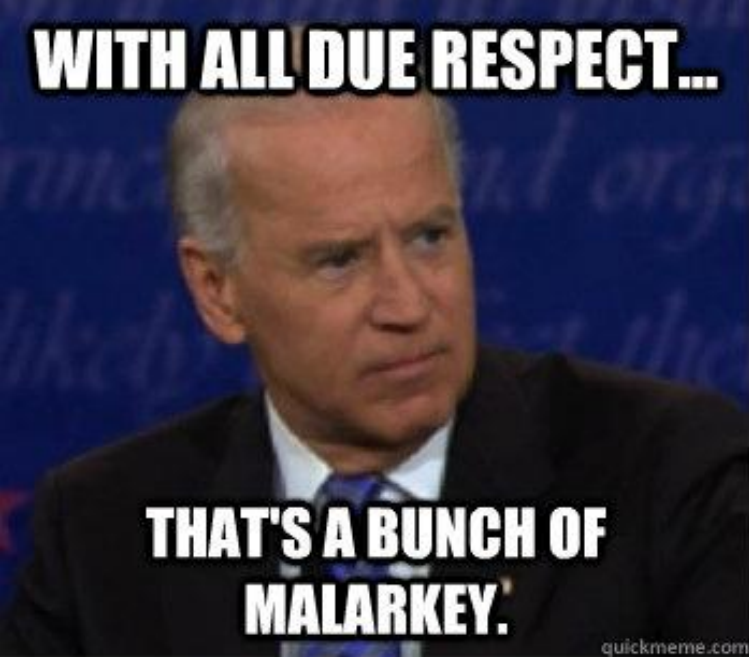
CT Explanation of Recessionary Gaps

3. Eventually, SRAS shifts to SRAS1 and the economy produces it's maximum output (Y^*) at a lower price level (PL1).

*****STAGFLATION is
considered a
RECESSIONARY
GAP!!!*****



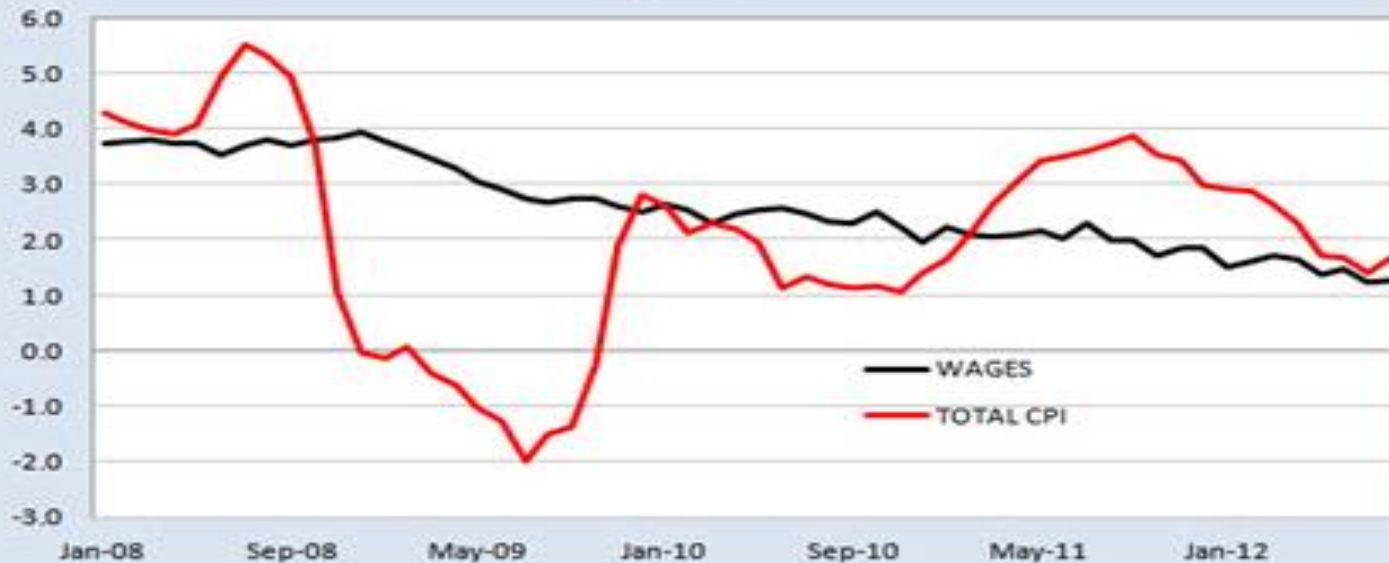
WITH ALL DUE RESPECT...



- Sorry Joe, this is the real deal.
- The black line below shows increases in NOMINAL wages since the recession began, the red is the inflation rate

U.S. WAGES vs INFLATION

YoY % ch.

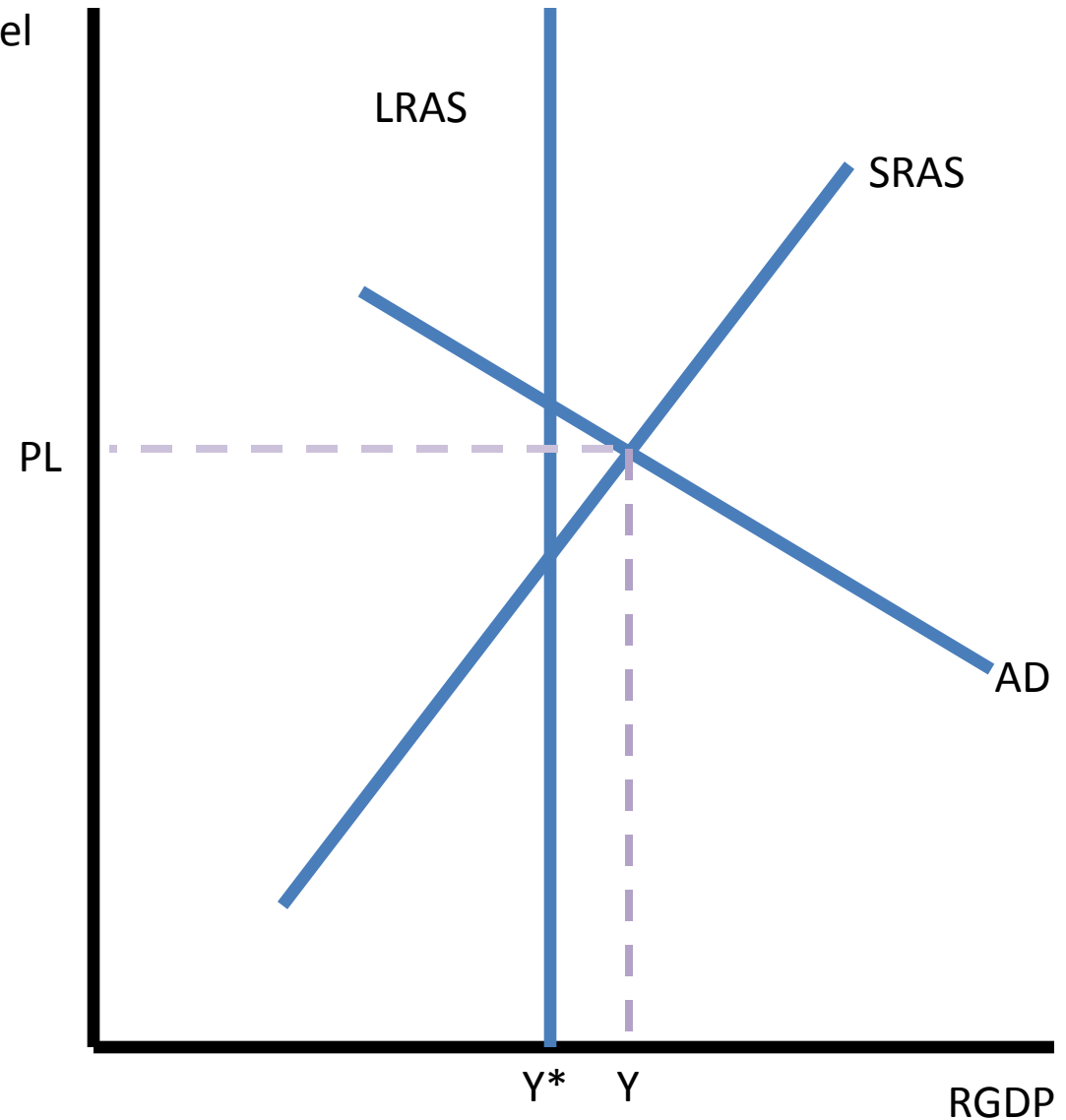


CT Explanation of Inflationary Gaps

Assumptions:

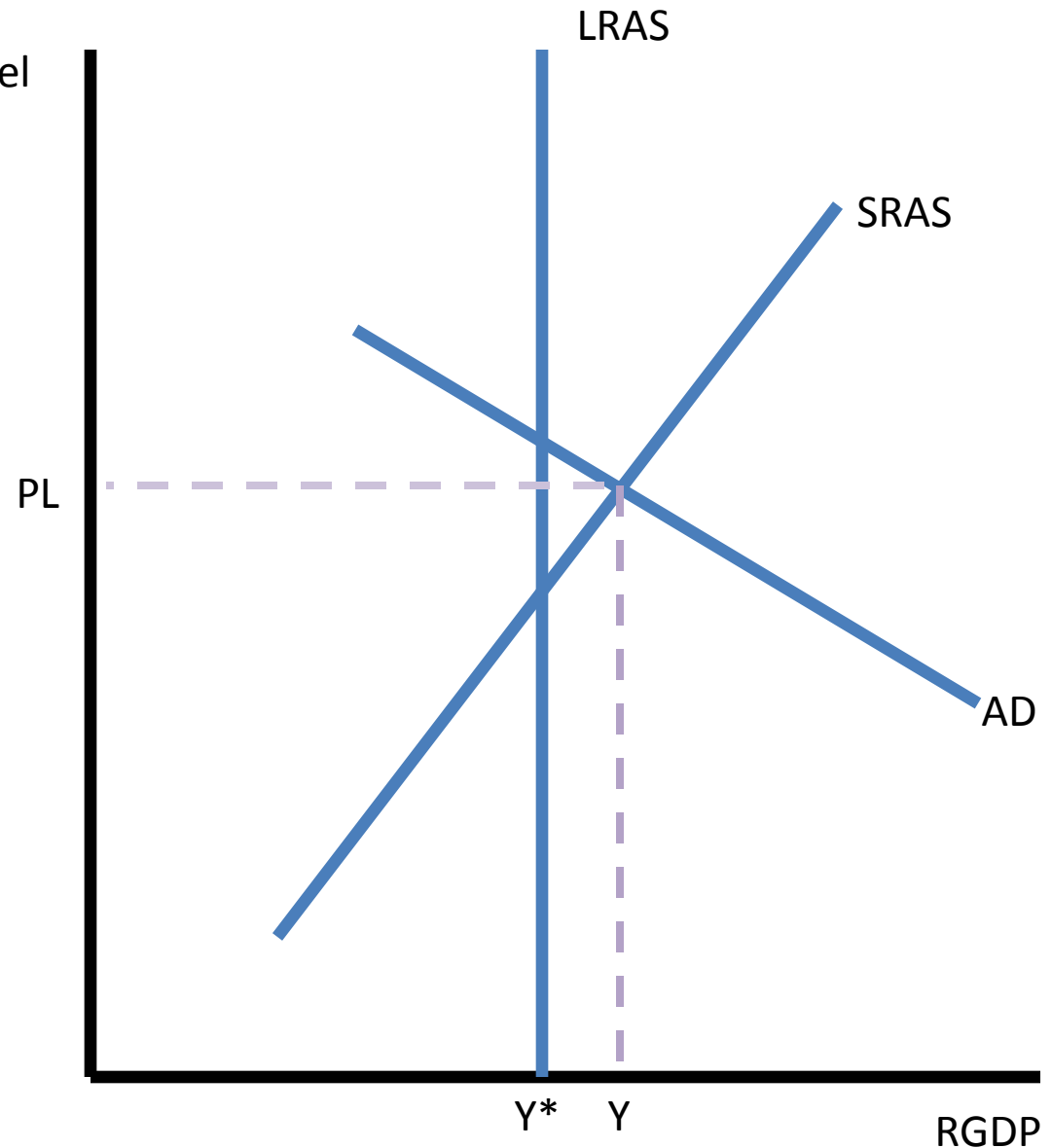
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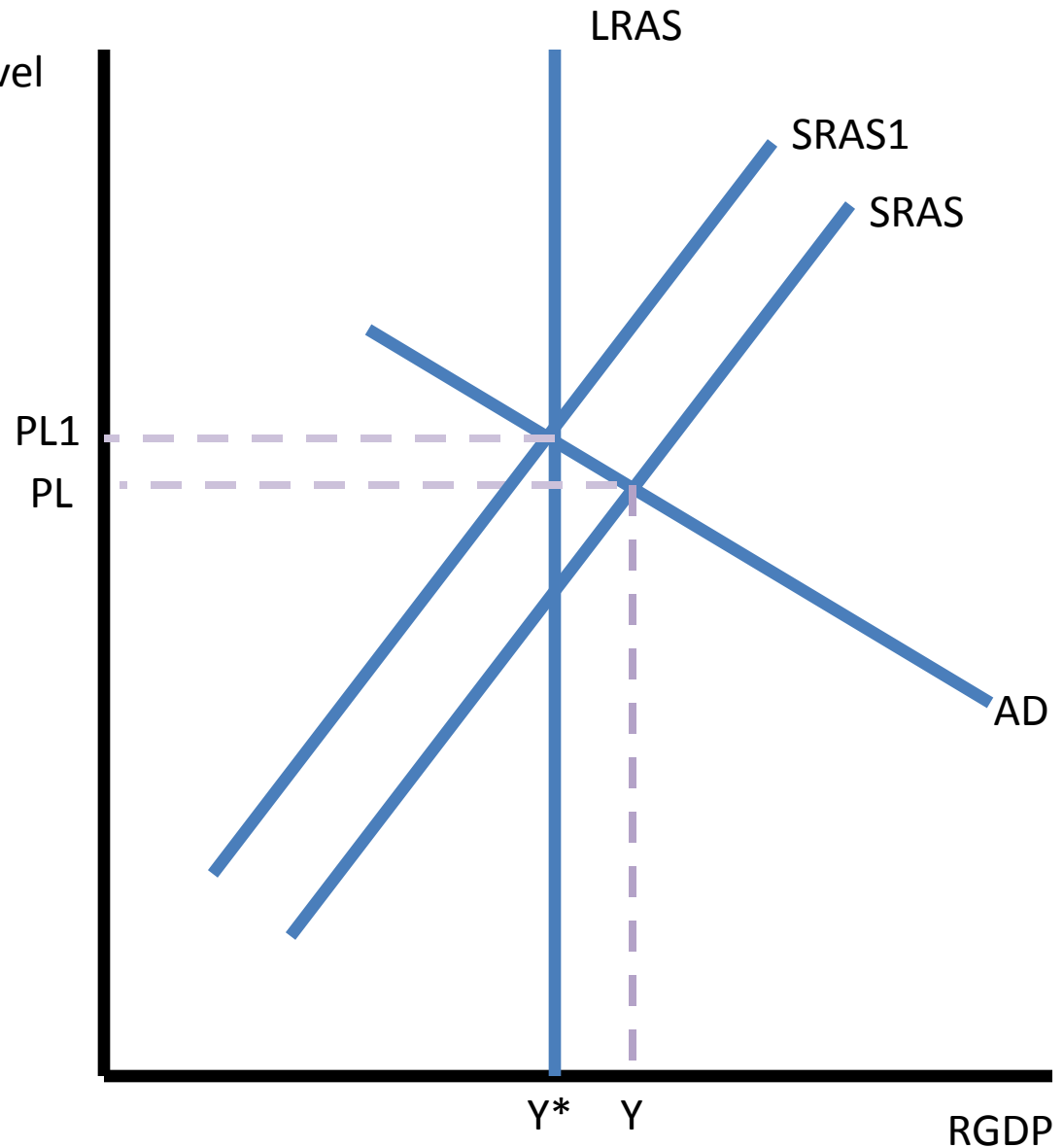
CT Explanation of Inflationary Gaps

1. Eventually this overproduction puts a strain on productive resources, causing the price of those resources to rise.
2. As the price of resources rises, businesses begin increasing prices (PL increases)
3. People realize their **REAL WAGES ARE DECREASING** slowly and they demand increased **NOMINAL wages**



CT Explanation of Inflationary Gaps

4. As NOMINAL wages increase, businesses rearrange resources and cut production back to sustainable levels (SRAS to SRAS1)



Summary

Recessionary Gaps

- UNEMPLOYMENT is the focus!
- People take wage cuts, SRAS increases

Inflationary Gaps

- INFLATION is the focus!
- REAL wages decrease, causing people to ask for NOMINAL increases in wages
- Increased wages leads to a DECREASE in SRAS

NOTE: BOTH FIXES RELY ON SRAS CHANGES, NOT AD

Summary: Issues

- Hard to debate legitimacy because Government and FED constantly at work in economy
- Critics say the idea of “flexible wages and prices” is naïve and unlikely in real world (despite evidence that it happens)
- No time-frame: may take years or decades to correct